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Financial Policy, Managerial Discretion and Corporate Governance

The Example of Usinor

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Financial Policy, Managerial Discretion and Corporate Governance

The Example of Usinor*

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ABSTRACT

This paper examines the proposition according to which financial policy and corporate governance structures are linked and change as parts of a dynamic process. Governance mechanisms constrain financing decisions, but in some circumstances the latter can also serve as a powerful vector in the implementation of a strategy to influence the limits of managerial discretion. The analysis of the Usinor case study illustrates the plausibility of the theoretical explanations.

Key-words : Financial policy, corporate governance, managerial discretion, mental pattern.

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Introduction

A casual international comparison of the financial structures of firms seems to indicate that preferred sources of finance are at least partially dependent on national context. Besides, in the case of certain countries, it is possible to observe considerable change. France is one such example. In this country, the equity-to-debt ratio of industrial firms has experienced considerable growth, beginning in the middle of the nineteen eighties[1]. Lannoo (1994) signals a link between the national specificities of governance systems and finance. He also finds a global decrease in the debt-to-equity ratio of French corporations since the middle of the last decade. This evolution of the relative weight of the principal sources of finance of French firms goes along with the increasing importance of market mechanisms inside the corporate governance system[2]. Concerning the latter, most international comparisons propose a classification of the different systems of governance according to the logic that dominates them. Hence, Moerland (1995) distinguishes systems, for which the market plays a dominant role, from those, that work on the basis of relational networks. These studies are an interesting starting block for an investigation of the mechanisms at work in the context of financing decisions taken by the managers in countries other than those of the Anglo-Saxon sphere[3].

In spite of the observation of a certain co-occurrence, the precise processes, which link corporate governance and financing decisions of the firm, still remain quite unexplored. Above, we have shown that the choice of finance of French corporations is not a static phenomenon. The dynamics, hence observed at the level of financing decisions, call for an explanation of the process linking corporate governance and the access to funds. What is the driving force behind financial policy and the change of governance structures? This research question, aiming at a deeper understanding of the dynamic relation between the limits of managerial discretion[4] and financing decisions, is characterized by a high degree of complexity. This is why the present study is of an exploratory kind. Far from being able to propose a complete theory of the financial implications of corporate governance, we present relatively open theoretical propositions, which serve us as research heuristics. In this context, the case study of Usinor is conceived of as an illustration of the plausibility of the proposed mechanisms. Not allowing for any a priori generalization to other firms, this single case can however contribute to a higher degree of precision of certain theoretical concepts.

The present article is structured in three sections. In order to illustrate the financial stakes of our research question, the first section consists of a presentation of the chronology of events in the Usinor case. The latter is still largely descriptive. The following section contains the conceptual framework, aiming at an explanation of the dynamic link between corporate governance structures and financial policy. Following the theoretical propositions, the third section focuses on the analysis of the Usinor case in relation with the explanations of the preceding section. The conclusion should thus allow us to respond to the question concerning the plausibility of the theoretical framework.

1. Chronology of Events of the Usinor Case

The Usinor group, as we know it today, has been created from two originally distinct steel corporations, Usinor and Sacilor. The steel industry is traditionally considered as being of strategic importance by the French State. Hence, the latter has a strong influence on the management of the two firms in the period after World War II. In this context, the public administration interferes directly with strategic decisions of the companies. The State actually decrees a freeze of the steel price and implements a social policy which makes a potential reduction of the number of employees difficult. The interdiction to raise prices weighs heavily on the potential to generate cash-flow, and the steel companies increasingly contract debt in order to finance their investments.

Since the steel industry is still considered a strategic sector, the State takes on the debt clims, becoming the most important creditor, because the financial situation becomes precarious. In the following course of events, the quasi-nationalization of Usinor and Sacilor takes place in 1978. In fact, in order to save the two companies, the State transforms its debt claims into equity. Hence, under the government of Raymond Barre, the French steel industry becomes state-owned, in some sort because of bankruptcy. Being the major shareholder, the State is however not the only owner of steel equity. In fact, some private stockholders remain, who control a certain proportion of the capital of the two firms. The formal nationalization of 1981 only makes official the state-ownership, which has already become a reality in 1978. Before the background of a very unstable financial situation, the top managers change with a relatively high frequency.

In 1986, a new government is elected. Alain Madelin, who is a self-declared liberal, becomes Minister of Industry. In September of the same year, Francis Mer is appointed by the government chairman of the two steel companies. This regrouping of the two entities, which, until then, were distinct, confers on a single manager the control over the whole French steel industry. It is interesting to note that before the regrouping, because of the existence of two companies, the steel business was characterized by a fratricide competition, implying often redundant investments for mere prestige's sake. Besides, one can observe that F. Mer takes over command at a time, at which Usinor and Sacilor find themselves in a situation of virtual bankruptcy, their equity being largely negative. From this follows the obligation to restore their capital before the end of 1986. Otherwise, a potential dissolution becomes possible. The State, being the principal shareholder and creditor at the same time, decides the restoration of the capital by a double "coup d'accordéon" (literal translation: accordion stroke). First, following this procedure, all equity shares are cancelled. As a consequence, the shareholders loose their property rights. This concerns especially the private investors, who still hold about 19% of the capital of Usinor and 8% of the capital of Sacilor. After this, the capital is increased by conversion of the debt claims of the State, implying *no* injection of fresh money. Finally, the capital is reduced once more in order to absorb past losses and to create a reserve to cover predicted losses. At the end of the operation, the State is almost the only shareholder. The danger of going bankrupt has thus been eliminated by a simple bookkeeping exercise.

Very rapidly, the new top manager implements a program of profound industrial restructuring. The Usinor Sacilor group begins to make profits in 1988 and generates a positive cash-flow. At the beginning of the nineteen nineties, the European steel crisis breaks out, and Usinor Sacilor falls back into a zone of losses. A capital increase, subscribed for by the Crédit Lyonnais, allows for an injection of fresh external funds (cf. appendix 1). From this moment on, the state-owned bank holds 20% of the steel company's capital. At the same time, this financial institution sends a representative to occupy a seat on the board of directors of Usinor Sacilor.

Once the steel crisis is over, the company of F. Mer returns to profits. A high cash-flow allows for a policy of debt reduction. In fact, the cyclical nature of the business – F. Mer has decided to focus on steel only – imposes the building up of a sufficient financial margin. Too high a debt level would make the company fragile in the case of a downward trend of the business situation. In 1995, the time seems to have come for the privatization of the Usinor

Sacilor group. Convinced of the interest of his company to be financed on the capital market, F. Mer does active lobbying aiming at the public administration in order to obtain for the firm to reintegrate the private sector. Finally, the decree of privatization is signed. The public offering is accompanied by a capital increase. The financial resources which are obtained this way are mainly dedicated to the effort of a continuation of debt reduction (cf. appendix 1). It is worthwhile to note that the reduction of the State's capital stake is accompanied by the departure of most of the state representatives on the board of directors. The majority of the new directors is chosen by F. Mer himself, as a function of the industrial strategy he pursues. This strategy largely dominates the financial policy, the financing being subordinate to the targets of development. Hence, the debt reduction which has been pursued for several years is not a strategic aim in itself. The financing policy is now clearly subordinate to potential acquisition opportunities, which could appear, allowing for a higher level of internationalization. At present, the executive level of the Usinor[5] group declares that it wants to profit from the whole array of modern techniques of active financial management.

2. Financing Policy and Managerial Action

After this brief presentation of the Usinor case, in this section, we present a theoretical framework concerning the dynamic links between financing and corporate governance structures. Before going further into the conceptual framework itself, it seems helpful to define a certain number of terms, which we will frequently employ (2.1.). Once the principal concepts have been defined, we will present a rapid review of the financial literature, which is potentially useful in guiding our understanding of the link between financing policy and corporate governance (2.2.). This analysis of certain contributions to financial theory will allow us to put into context the research propositions (2.3.), which constitute the very heart of the conceptual framework.

2.1. Some Definitions

The research question which motivates this paper calls, first of all, for a clarification of what we mean by *financial policy*. Here, the term *policy* already hints at a theoretical postulate, because it supposes that the CEO has a certain degree of liberty of action. Hence, the choice of finance does not follow a perfect structural determinism, but is made by the top manager who is a strategic player. In this context, our research problem focuses attention on all decisions allowing the firm to gain access to the funds necessary to realize its value creation strategy[6]. The examination of the link with corporate governance issues implies a concentration on financing of a strategic nature. Hence, the daily management of liquidity is excluded from our field of investigation. Concerning the different types of financial resources, it is possible to make a first distinction between internally generated funds and external finance. A priori, the latter seems to be more restrictive for the CEO than the first[7], because it generally goes along with a certain number of mechanisms aiming at the protection of the investors' interests. At the level of external funds, the distinction between debt and equity seems too limited to take into account the dynamics of the link between financial policy and corporate governance. For this reason, we prefer to identify the financing choices directly by the investor type, who grants the firm access to his resources.

In fact, corporate governance aims at the protection of the interests of different investor types. The identification of the sources of finance by investors is thus likely to capture the dynamics of managerial discretion. To give just one example: It is probable that a company being part of a *noyau dur* (group of permanent shareholders) because of industrial politics does not necessarily pursue the same interests as a pension fund responsible for old-age pensions. However, the two contribute to equity finance.

Financial policy and corporate governance appear to be dynamic phenomena. In order to examine the process which links these two phenomena, it seems important to make explicit the kind of rationality required for a dynamic approach. Such an approach relies, in fact, on the hypothesis of *procedural rationality*. Simon (1982)[8] defines it as follows: "Behavior is procedurally rational when it is the outcome of appropriate deliberation." (p. 131). This definition is the logical consequence of the idea, according to which human cognitive capacities are limited. Hence, "appropriate deliberation", though it may use rational information processing techniques, calculating solutions, can never be exhaustive. If the set of potential choices of a decision maker is not determined ex ante, the deliberation process can lead to the discovery of new choices, which were not included in the parameters at the outset. Consequently, the mental patterns (or heuristics) are potentially a source of change.

The theory of institutional change proposed by North[9], which has inspired much of the conceptual framework in this section, also relies on the idea of cognitive limits. According to this theory, the perception of opportunities by an *organizational entrepreneur* is the starting block of institutional evolution. Concerning the strategy of the creation and the distribution of value inside the firm, this perception is shaped by the mental pattern of the CEO (who is one potential organizational entrepreneur among others). For North, a mental pattern is simply a theory an individual holds on reality. The decision maker thus acts not directly in response to an external and objective reality, but as a function of the representation he has of reality. Concerning an investigation of financial policy in relation with corporate governance, a more restrictive definition of the *mental pattern* seems appropriate. For the rest of the paper, we propose to refer to it as *a representation of the role of different stakeholders in the value creation process as well as of the appropriate remuneration for their services*. The mental pattern thus contains a positive dimension (representation of cause-ends relations) and a normative dimension (legitimacy of value distribution)[10].

The distribution of the created wealth concerns directly issues of *corporate governance*. The latter is defined by Charreaux (1997) as "*the set of mechanisms which result in a limitation of the powers of the CEO and exert an influence on his decisions. In other words,* [we speak of the mechanisms] *which 'govern' the managers' conduct and define their discretion* [emphasis in original]" (p. 421-422). A different definition is proposed by Shleifer and Vishny (1997)[11], who concentrate on the mechanisms assuring the investors a certain return on investment. This approach has the advantage of emphasizing the role of the relations with the providers of financial resources. From this follows a conception of *corporate governance* as the set of mechanisms limiting managerial discretion in order to obtain an alignment of the CEO's strategy with the interests of the investors. A priori, this definition seems well adapted to modeling the links between financial policy and corporate governance. It is also helpful to note that there are different levels of corporate governance mechanisms. In fact, we differentiate between a country's global corporate governance system and the local governance structures, which regulate the managerial discretion of a particular CEO. As it is probably at the level of the local structures that the manager can exert the most direct influence, the link between corporate governance and financial policy seems a priori to be most intense at a local scale.

It is also useful to be conscious of the fact that even the most constraining control and incentive system always leaves some room for managerial discretion. This observation is consistent with the conception of the CEO as an active player and not as a passive executioner of financing choices, which would be predetermined by the structural environment. It is *managerial discretion* which potentially confers on the top manager his ability to become an organizational entrepreneur in the sense of the theory of North. According to the latter, by their actions, the chairpersons of organizations exert some influence on institutional evolution. Following this approach, the CEO of a firm becomes an entrepreneur if he is the source of a modification of the institutional environment. Hence, the dynamics of corporate governance depend, at least partially, on the degree of liberty of action which characterizes the top manager of a firm. The width of this margin of managerial discretion is dependent on the limits defined by the governance structures in place at a given instant, as well as on the means of action that are available to the manager for the implementation of his strategic will to make existing structures evolve. Managerial discretion thus has to compose with time. It is a dynamic ability rather than a static reality. We shall see later on that the availability of finance is a powerful lever for the active management of the space of managerial discretion.

2.2. Contributions and Limits of Traditional Approaches of Corporate Finance

Since the nineteen seventies, agency theory has made a case for the relation between incentive and control structures on one side and financial choice on the other. The seminal work of Jensen and Meckling (1976)[12] is generally quoted as one foundation of this research current. The basic idea is to consider the potential conflicts of interest between different categories of stakeholders. These conflicts motivate the principal to put into place control mechanisms which limit the agent's discretion in order to obtain an alignment of interests.

Costs are induced by the setting up and the subsequent functioning of control structures. Other agency costs find their origin in bonding and the residual loss. The existence of the latter is an indicator of the impossibility of reducing managerial discretion to zero. The foundations of positive agency theory are very large. The financial model which Jensen and Meckling (1976) deduce from this is more restrictive, because it mainly concentrates on the relation between shareholders (principal) and manager (agent), as well as on the relation between shareholders and creditors, and explains the effects on financial structure. The logic underlying this approach is the efficiency principle. One deduces from this that the choices of finance actually observed are those which minimize agency costs, which are appreciated by reference to shareholder wealth[13]. Interpreted in the light of the definition of corporate governance as presented before, the financial model to which agency theory has given birth considers a certain number of governance mechanisms as being directly attached to different types of finance. Hence, debt, for example, brings along a certain number of mechanisms reducing managerial discretion because it allows for a reduction of free cash flow under the manager's control (see Note 7). However, this first financial model of agency theory encounters two major limitations, that is to say its fundamentally static nature and an insufficient reference to institutional context. Casual observation reveals however that institutional context influences the control mechanisms that go along with different types of finance[14]. Besides, the exclusive emphasis put on the relation between CEO and shareholders in the principal-agent model can be interpreted in the light of a mental pattern, which quite seems to be of the Anglo-Saxon type. Charreaux and Desbrières (1998), however, put into question the universal applicability of a representation of value in the form of shareholder value. The preceding arguments indicate that a simple transposition of the financial model of agency theory to an institutional context outside the Anglo-Saxon sphere is likely to induce serious bias in our understanding of the relation between financial structure and corporate governance.

The financial models which have been developed to explain the functioning of the market for corporate control[15] emphasize the strategic dimension of the choice of finance from the point of view of the interests of the CEO. In this approach, the choice of finance appears as a means for the manager to protect his position by neutralizing the constraint emanating from a hostile takeover attempt, which can be qualified as a spontaneous governance mechanism (see Note 4, p. 427). Rather than being a mechanism to control the actions of the CEO, imposing itself by its ability to maximize shareholder value, here, financial policy appears as an instrument serving an active management of managerial discretion.

Entrenchment theory, in particular, is concerned with the analysis of the mechanisms a manager can use to enlarge his space of discretion. One of the merits of this theoretical current is to insist on the dimension of time in the personal strategy of the CEO[16]. Hence, entrenchment appears as a dynamic process, in the course of which the manager is capable of neutralizing certain limits of his range of discretion. Such a change of constraints can take the form of a modification of governance structures. But, what are the CEO's motivations to follow a strategy conferring on him a certain degree of discretion? Castanias and Helfat (1991, 1992)[17] propose a model, in which the manager decides on his actions as a function of the possibilities of creating and appropriating rents. This approach completely reverses the perspective of the principal-agent model because the CEO becomes a potentially important resource, contributing to the process of value creation in the form of managerial rents. The traditional principal-agent relationship can thus be reversed, the CEO appearing as the principal, subject to the risk of an expropriation of the fruits of his investment by the shareholders.

Like the financial model of traditional agency theory, entrenchment theory suffers, however, from an insufficient reference to institutional context. At this level, the theory of institutional change by North[18] allows to shed new light. Inside of this theoretical referential, the organizational entrepreneur's perception of opportunities is the driving force of institutional change, institutions being the rules of the game constraining the actions of the different players. Seen through the lens of institutional theory, corporate governance is based on a set of institutions. As an example, we can cite the existence of a more or less active market for corporate control, which constrains the CEO by imposing on him a more or less important risk of losing his position. Thus, such a market is an institution, the importance of which for corporate governance depends on the global institutional framework of a country. In this context, and in a manner consistent with North's theory, the CEO is faced with an arbitrage between the governance structures in place and a possible change of these structures. All depends on his perception of the opportunities related to each of the two possible choices. This perception is shaped by the manager's individual mental pattern. At this level, it is useful to recall the Castanias and Helfat model. In the light of the theory of institutional change, it is, in fact, possible to put into context the logic of creating and distributing rents. Hence, if it is not some objective reality but the perception the manager has of it, which is determining, his perception of rent creation and appropriation opportunities as a function of the evolution of managerial discretion is at the very heart of the dynamic process, which links financial policy to corporate governance.

But, the CEO's will to bring about a change in governance structures alone is not sufficient for the realization of such a strategy. At this level, financial policy appears as one powerful lever of action for an active management of managerial discretion. The impact the choice of finance has on the range of discretion can be either direct or indirect.

- It is direct when the choice of finance coincides with the choice of governance structures. Ravid and Sudit (1994)[19] propose, in fact, a hierarchy of different types of finance as a function of the degree of liberty they leave to the CEO. In this context, cash-flow appears to be the less constraining source of finance.
- The impact of finance on managerial discretion can also be indirect because the availability of financial resources, at a given instant, can help to make investments which are complementary with the manager's human capital, thus reducing the risk of the CEO of being replaced[20].

2.3. Finance, Managerial Discretion and Corporate Governance – Theoretical Propositions

As a conclusion of the developments of the preceding section we can state that the relation between corporate governance structures and financial policy appears to be dynamic. Theoretically, three types of sequence in the course of a firm's evolution in time should be considered: the governance structures in place facilitate access to certain categories of finance[21], the choice of financial resources and governance structures takes place simultaneously, the availability of financing precedes a change of the range of managerial discretion. Consequently, at different moments of a firm's trajectory corresponds theoretically one of these three sequences. The direction of the causality between finance and governance can be reversed in the course of time. The following schema presents a hypothetical example of such a process, for which the perception of the possibilities of rent creation and redistribution constitutes the link between the different stages.

Governance → Finance → Governance → Simultaneous choice

The propositions derived from this theoretical framework are intentionally large. This study being of an exploratory nature, the objective is not to formulate closed, and thus refutable, hypotheses in a traditional sense. They have rather been conceived of as research heuristics, allowing for a structured exploration of the terrain.

Corporate governance structures allow for an alignment of the CEO's behavior with the interests of certain investor types. Hence, the role of the control mechanisms is to avoid potentially opportunist actions by the manager, which would amputate the investors' remuneration for their contribution to the value creation process, remuneration which is judged to be legitimate. The existence of mechanisms which reduce the risk of *ex post* opportunist behavior also constitutes an *ex ante* incentive for potential investors to put their money into the company. To cite one example, it seems quite realistic to suppose that a bank's representation on the board of directors of a firm is likely to facilitate the access of that company to funds managed by this very bank. In spite of the fact that we exclude perfect structural determinism, the governance structures in place at a given instant delimit the set of potential (financial) choices. This justifies the following proposition.

Proposition 1: Corporate governance structures contribute to constrain the set of possible choices of finance.

As corporate governance structures delimit the set of financing alternatives, their modification also brings about a change of the perimeter of financial policy. In fact, the range of managerial discretion is not rigid, but evolves over time. These dynamics exert an influence on the firm's ability to gain access to resources. The introduction of a new governance mechanism can thus open new financing opportunities, but does not necessarily so. In fact, it can also eliminate existing sources. Consequently, the availability of different types of financial resources evolves as a function of constraints on managerial discretion.

Proposition 1 a: A modification of the firm's corporate governance structures brings about a modification of the set of financial resources potentially available.

Before they make funds available to the CEO, external investors are likely to demand that the flow of resources be accompanied by a certain number of governance mechanisms. This aims at a protection against an expropriation of their part of the fruits of the investment. In the case the CEO has recourse to an investor category which does not already contribute to finance the firm, it is likely that the injection of resources takes place simultaneously with the installation of new governance structures. As an example, it is possible to imagine that an investor asks for a seat on the board of directors as a condition prior to his engagement. As a bonding mechanism, it is also possible that the CEO himself proposes a seat to the new investor. In spite of the fact that in this case the initiative is not taken by the same person, the result is identical.

Proposition 2: The choice of external finance made available by a new investor coincides with adjustments of the governance structures. This is a simultaneous decision.

The manager's mental pattern shapes his perception of the opportunities of creating and appropriating rents. In certain cases, this can lead to the perception that changing governance mechanisms is more advantageous from the perspective of the CEO's personal strategy than evolving inside of the existing structures. Hence, the manager makes an arbitrage between continuity and change of corporate governance, the discriminating criterion being his representation of the possibilities of rent creation and appropriation. Hence, the introduction of mental patterns does not imply that we reject the idea of calculus in the process of decision making. On the contrary, in the conceptual framework presented here, the CEO makes his arbitrage as a function of a calculated comparison, pondering **perceived** costs and benefits of different courses of action. What is different from approaches founded on substantive rationality is that the calculus concerns a **model** of reality rather than a supposedly objective reality. The mere will to bring about a modification of governance structures however does not imply that the CEO disposes of the means necessary to implement such a strategy. At this level, financial policy is potentially a powerful lever of action for an active management of the range of discretion.

Proposition 3: The availability of financial resources allows the CEO to actively manage his range of discretion and, thus, part of the governance structures.

Theoretical analysis is quite unanimous concerning the relatively unconstraining nature of excess cash-flow. Hence, a differentiation of different types of finance according to their internal or external origin seems appropriate for an investigation of managerial discretion. Beyond this fundamental dichotomy, however, it seems hazardous to establish an a priori hierarchy of different types of external finance, as proposed, for example, by Ravid and Sudit (1994). The fundamental dichotomy between external and internal finance is justified by the fact that a recourse to external investors increases the number of stakeholders of the firm. As these new stakeholders have their own particular interests, an increase in their number is likely to introduce an additional constraint of managerial discretion.

Proposition 3 a: Excess cash-flow[22] is the financial resource for which the allocation by the CEO is the less constrained by the other stakeholders. Its appearance creates an opportunity to make managerial discretion work effectively.

The implications of different types of external finance in terms of managerial discretion appear to be more difficult to appreciate by a priori reasoning than the consequences of internal as compared to external resources. To study a hierarchy of external finance without considering the particular (national) institutional context seems difficult at best, if not impossible. An appreciation of the availability of external financial resources thus has to take into account the demands of potential investors in terms of mechanisms allowing for a protection of their interests. In particular, these interests may concern a remuneration judged to be satisfactory. The investors' demands are represented in their mental patterns. A close distance between the representations of potential investors and the individual mental pattern of the CEO facilitates the access to external funds which are likely to contribute to finance a strategy aiming at an extension of managerial discretion.

Proposition 3 b: Investors' perception of the CEO as being capable of creating managerial rents facilitates access to external resources. Such external funds can serve as an instrument for a strategy aiming at a change of governance structures. They are however relatively more constraining than excess cash-flow.

The underpinning logic is as follows. When the manager perceives an opportunity of rent creation but does not dispose of a sufficient amount of internal resources, he may have recourse to external investors. If he considers that the potential of value creation exceeds the disadvantages following from an additional constraint imposed on his managerial discretion, he is likely to make his decision in favor of such an external financial resource. As the *ex post* success of this strategy in terms of creating rents will probably reinforce the potential of generating internal finance later on, a future increase in managerial discretion may be anticipated. At this level clearly appears the dynamic nature of the concept of range of discretion.

3. The Usinor case: From Quasi-Bankruptcy to Active Management of Financial Resources

After the presentation of the conceptual framework, we shall now turn back to the Usinor case, submitting it to systematic analysis with reference to the theoretical propositions. The following results have been obtained by closely analyzing data from several sources. In this context, a great part of the financial information were extracted from the group's annual reports from 1986 to 1996. In particular, the data concerning the evolution of the financial structure (appendix 1) are of this origin. Besides, we were able to directly meet with three persons who have positions either on the board of directors or close to the CEO[23]. In fact, we had encounters with one member of the board, with the general secretary and with the person in charge of investors relations. The interviews were tape recorded or notes were taken. In order to further our comprehension of the case, we had also access to the archives of the Usinor group. This allowed us to compile comments of the press concerning the steel producer's principal evolutions between 1986 and 1996. In addition, the archives yielded the transcript of a speech given by Francis Mer (CEO) and Robert Hudry (Financial Executive) at a presentation of the group in 1995, preparing its privatization. The data, mainly qualitative, were submitted to a formatted content analysis. In other words, they were codified according to a list of themes, directly derived from the conceptual framework. The codes correspond to the following themes: finance, governance, managerial discretion, mental pattern, rent creation and rent redistribution.

We should finally note that this single case study does not represent an empirical test of a set of hypotheses in a traditional sense. It has rather been conceived of as an illustration of the plausibility of a certain number of concepts of the theoretical framework. In fact, before going any further, the objective is to examine if, with some relatively simple concepts, one can explain the development of the financial policy of a real firm.

3.1. The State's Role in the Resolution of the Crisis

In the period of State interventionism after the second world war, the government decrees a freeze on steel prices. At that time, corporate governance is thus characterized by the important weight of the State, which imposes a direct constraint on the group's strategy. This situation, in conjunction with important public pressure against potential reductions of the employment level, leads the steel industry to a deficit of internal finance. Hence, in lack of cash-flow, the industry takes on large amounts of debt in order to finance its investments. Such an evolution appears to be coherent with **proposition 1**, according to which the governance mechanisms working at a given instant – here, we observe the case of direct State interventions – influence the set of possible sources of finance. The result is a progressive degradation of the financial situation, which reaches a first critical point in 1978. At that date, the State decides to transform its debt claims into equity. Hence, the steel firms come under State control because of bankruptcy. At that very moment, it is thus the bad financial situation, that is to say a lack of internal finance, which brings about a change of the governance structures. The steel firms are nationalized. This national standing reinforces the influence of the State even more. The managerial discretion of the CEOs appointed by the government is much reduced. This translates into a high rotation of the top executives[24] before the arrival of Francis Mer. Usinor and Sacilor, incapable of financing their investments out of cash-flow, are hence financed by public funds. The governance mechanisms, for which the State plays a dominating role, thus favor a certain type of external finance. During the entire period of the ten years preceding 1986, the amount of subsidies destined to the steel industry is estimated to be about 100 billion French Francs (*Le Figaro*, August 30, 1986). The State, having taken control of the capital, feeds the steel industry with public funds out of fear of the social consequences of its potential disappearance. The steel business is hence a highly politicized affair, giving an incentive to government executives to support its existence by the injection of massive aid.

But, the European Commission considers public aids to industry as an obstacle to free competition. For this reason it prohibits all direct subsidies to the steel business from December 31, 1985 on. Before this date is decided one last program of aid destined to the French steel firms of an amount of 20 billion French Francs (*Les Echos*, September 2, 1986). The payment of this subsidy is spread over several years. At that moment, the steel firms are incapable of having recourse to the capital market. Thus, they must manage to get along with this last injection of external resources coming from the State and with their own forces, in order to assure their future. Hence, the prohibition from Brussels reinforces the steel industry's obligation to restore its capacity to generate cash-flow. The constraint imposed by the European Commission thus directly concerns the possibilities of external finance. In accordance with **proposition 1 a**, the modification of governance structures, which consists in this case of a reduction of managerial discretion caused by the regulatory framework, brings about a modification of the set of potentially accessible sources of finance.

As an improvement of the results is not expected immediately, however, and the two firms are virtually bankrupt, the State must nevertheless intervene. In fact, their capital being negative, Usinor and Sacilor have a legal obligation to restore their very capital before the end of 1986. It is in this context that Francis Mer arrives. The solution which is envisaged and implemented with the State's support is the following. In fact, the capital is restored by a simple accounting exercise. The existing capital shares are declared null and void. Following this operation, the capital is increased by transformation of the State's debt claims and, immediately afterwards, reduced once more, in order to absorb past losses and to create a reserve for anticipated future deficits. In this way, State debt claims of about 50 billion French Francs are converted (*Agefi*, September 22, 1986). This operation simultaneously ameliorates the financial situation of Usinor and Sacilor and avoids another payment of public funds, prohibited by Brussels. Hence, the operation appears as a simple transformation of the legal characteristics (debt exchanged against capital) of financial resources that had already been allotted before. The investor involved here, that is to say the French State, stays unchanged. The strong constraint emanating from the heavy weight of debt is thus loosened by a conversion into capital, the principal source of finance being all the same. Following this operation, the new CEO finds himself with a more solid basis for his action, allowing for the pursuit of a strategy of deep reaching restructuring. This exchange of debt against equity and the resulting increase in managerial discretion seem to correspond to the hierarchy of finance established by Ravid and Sudit (1994). According to these authors, debt is in fact the most constraining type of finance.

We should also note that, at the moment of this double *coup d'accordéon* (literally: accordion stroke) on capital, 19% of Usinor's and 8% of Sacilor's equity are still in the hands of private investors. These capital shares represent a market capitalization of about 460 million French Francs (*AFP*, September 19, 1986). As a result of the recapitalization scheme, the private investors are deprived of their claims, and the State is practically the only one left holding stock of the steel firms. The Ministry of Finance justifies this procedure by invoking the obligation of all stockholders to contribute to the restructuring effort. One does not see why the State should be the only stockholder concerned by the two companies' losses.

With the recapitalization, the State endows the new CEO with a solid starting block. In fact, the firms' management finds itself liberated from the menace of going bankrupt, which was imminent for the end of 1986. It is also interesting to note that the State calls for Francis Mer as a specialist of industrial strategy with the reputation of someone capable of redressing a firm (*Le Monde*, September 4, 1986). Hence, the new CEO goes to work realizing a program of deep reaching industrial restructurings. The effort to optimize the structures of a group, which has inherited from its past a lack of coherence, yields positive results, with profits occurring for the first time in 1988. At this level, one observes that an increase in managerial discretion is not incompatible with efficiency. On the contrary, it may contribute to improved performance. This seems to be coherent with the approach defended by Castanias and Helfat (1991, 1992). Besides, the return to profits allows the group to generate internal finance in the form of cash-flow. Thanks to the latter (and to a new transformation of State-owned bonds in 1988[25]), Usinor Sacilor pursues a policy of debt reduction, in order to increase its range of action.

3.2. Crédit Lyonnais Takes a Capital Stake

At the beginning of the nineteen nineties, the European steel crisis breaks out. In 1991, Usinor Sacilor falls back to deficits. A capital increase, at the occasion of which Crédit Lyonnais injects 2.53 billion Francs of fresh money, allows to live on during the crisis. This contribution of external finance is authorized by the Brussels Commission, which does not see in it some sort of disguised public aid. According to an inquiry led by independent auditors, Crédit Lyonnais has, in fact, made its decision to invest in Usinor Sacilor without being influenced by the State and according to the criteria of profitability which normally serve to appreciate this type of investment (*Financial Times*, November 27, 1991). Hence, in addition to the State, this nationalized bank holds a participation of the capital of Usinor Sacilor of 20%. The injection of external funds stemming from this new investor is accompanied by a modification of the governance structures of the steel company. In fact, from that moment on, the public bank occupies a seat on Usinor Sacilor's board of directors. Its representative is Jean-Yves Durance. Hence, one observes a simultaneous change of the financial structure and of the composition of a control organ. These events correspond, in fact, to **proposition 2**, according to which the choice of external finance coming from a new investor coincides with adjustments of the corporate governance structures.

3.3. Access to Financial Resources and Strategic Choice

In 1994, Usinor Sacilor returns to profits. In this context, the cash-flow allows for the continuation of the policy of debt reduction. Finally, in 1995, thanks to a substantially ameliorated financial situation and in a favorable business environment due to a positive evolution of the steel market, the CEO perceives the opportunity to privatize the group. Being convinced that this is the right moment, he does active lobbying . He needs, in fact, the State authorities' support for the operation aiming at a return of his group into the hands of private investors. The firm's executive committee is convinced that its competitive advantage depends on internationalization. But, with the State as the principal investor, the top management feels that there are constraints which are opposed to the realization of such a development. The latter is, however, perceived by the CEO to be an important source of future performance. The motivation behind the privatization is described in the following terms: "It is of course the access to private capital, which is prepared, and it is also the fact that the separation from the State implies that one is *free to invest* [on an international scale]."[26] According to the group's executive committee's representation, it is thus a partnership with private investors which promises the best opportunities of value creation. Hence, a change of governance structures (privatization) is wanted in order to gain access to the capital market. This observation supports **proposition 1 a**, which indicates that a modification of governance mechanisms brings along a modification of the set of financial resources potentially available.

In the case of Usinor, the financial policy having recourse to the capital market aims at a contribution to the realization of an investment strategy which is supposed to create value. At this point, it is helpful to recall the fact that the conceptual framework presented above shows us that the perception of opportunities to create and to appropriate rents is an important incentive for the CEO - in the role of an organizational entrepreneur – to pursue a modification of governance structures. By considerably reducing the weight of the public authorities the privatization brings about a change of the control mechanisms and, thus, of the limits of managerial discretion. Hence, after having joint the private domain, it is the CEO himself who freely chooses the main proportion of the members of the board of directors as a function of his development strategy[27]. In this context, certain persons having a great international experience join the board.

The signature under the decree of privatization opens the way. The transfer to the private sector is accompanied by a capital increase, allowing for an injection of funds coming from private investors of an amount of 5 billion French Francs. This money is mostly allocated to the continuation of the effort of debt reduction. At that time, Usinor's top management declares the reduction of the debt level to be a priority, in order to give the group greater liberty of action. This liberty should allow Usinor to profit from acquisition opportunities. The latter are likely to support the objective of international development. At this level, it appears clearly that available funds can be used for an active management of managerial discretion, which increases confidence in **proposition 3**. The argument cited in favor of debt reduction is, in fact, its positive impact on an enlarged liberty of action.

It is interesting to note that, during privatization, a stable group of stockholders is put in place. The members of this group acquire 15% of the capital (3% of which go to Crédit Lyonnais) in an over-the-counter transaction. It is Francis Mer himself who chooses the companies to become stable stockholders. A further examination of the capital structure after privatization indicates that the proportion of capital which is widely held is very small. In fact, it is institutional investors that most contribute to finance the steel company at the time of privatization. As far as these institutional investors are concerned, the proportion of Usinor stock held by American investors is presently estimated to be 15%. This important presence of foreigners indicates that the French steel producer is involved in the competition for financial resources in an increasingly globalized capital market. At this point, it is helpful to recall **proposition 3 b**, according to which potential investors grant the firm access to their funds as a function of their perception of the CEO as being able to create rents. Does the proportion of different investor types in the capital structure indicate a more or less important convergence of their mental patterns with the CEO's pattern? At this stage, it seems difficult to answer his question definitely. However, the Usinor management emphasizes the "high degree of morality"[28] of the Anglo-Saxon funds. This positive judgement concerning the interests of this investor type could be a signal concerning the closeness of mental patterns.

We would also like to indicate that for the Usinor management the minimization of debt "is not a dogma."[29] Hence, the CEO takes the liberty to have temporary recourse to debt, in order to profit from potential external growth opportunities, reinforcing international development. The structure of the balance sheet presently makes debt finance possible. The general assembly of June 1998 hence authorizes the board of directors to create bonds. The same general assembly gives the firm the authorization to buy its own shares in the market. The Usinor management signals its will to pursue a financial policy using the whole range of the instruments of active modern financial management. Consequently, starting from a situation where financial choice was extremely restraint, Usinor has attained a stage where financial resources are managed in an active way. In the process, which has allowed to reach this point, the restoration of internally generated cash-flow has played a central role. Hence, internal financial resources are an important lever for the exercise of managerial discretion (**proposition 3 a**).

Conclusion

At the beginning of this study, we made the observation that financing of firms in different institutional contexts changes over time. At the same time, corporate governance systems seem far from being static. These observations have motivated the exploration of the mechanisms at work in the process linking financial policy and governance of a big corporation over time. In fact, the theoretical developments show that the relation between control structures and financial choice is potentially dynamic and interactive. Hence, it appears that three types of sequence are theoretically possible. In fact, being constraint by the corporate governance structures, which delimit managerial discretion, financial policy is also a powerful lever for the implementation of a strategy aiming at a modification of the range of discretion. In addition, a decision may concern the ways to raise finance and the governance mechanisms simultaneously.

In order to illustrate the plausibility of these concepts and to advance further in the direction of a better understanding of the process, we have studied the case of a large French industrial company. The history of the Usinor group globally reinforces the confidence we have with respect to the theoretical propositions. In fact, the case study shows that, in the course of time, Usinor passes from a situation where the choice of finance was very much restraint by the structural context, to a stage where an active financial policy allows to widen the limits of managerial discretion.

However, we must acknowledge that, in spite of these encouraging results, the significance of the latter is necessarily restraint. In fact, it is not possible to generalize from a particular case to a larger population. In order to increase the degree of generality of the propositions, one would need to examine a larger sample of firms. Hence, the present study is above all exploratory, trying to go a bit further in our understanding of the functioning of certain micro-processes. With respect to this objective, the results we have obtained augment our confidence in the validity of the theoretical orientation we have chosen.

Notes

1. Deutsche Bundesbank, " Eigenmittelausstattung ausgewählter EG-Länder im Vergleich," *Monatsbericht*, October (1994) p. 75.
2. In this context, K. Lannoo, "Le gouvernement d'entreprise en Europe," *Revue d'Economie Financière*, no. 31 (1994) indicates that France has developed a national takeover market (p. 167).
3. The debate on corporate governance has its origins in the Anglo-Saxon countries. Not surprisingly, the mechanisms of the institutional context of these countries have been the object of most attention by researchers. This explains why the "Anglo-Saxon system" is often quoted as a reference.
4. Managerial discretion is defined as the liberty of action of the manager. According to the definition of corporate governance proposed by G. Charreaux, " Vers une théorie du gouvernement des entreprises." In G. Charreaux, ed. *Le Gouvernement des Entreprises* (Paris, Economica Recherche en Gestion. 1997) pp. 421-469, governance imposes limits on managers' powers. The limit of managerial discretion, which concerns, among other things, the choice of finance, is thus traced by the governance structures.
5. Since June 1997 the group is simply called Usinor (instead of Usinor Sacilor).
6. As we shall see later on, the driving force behind the process of choice is the **perception** of value creation. It is the CEO's mental pattern which determines whether this perception refers to the creation of shareholder value or stakeholder value.
7. M. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers," *The American Economic Review*, vol. 76, no. 2 (1986) pp. 323-329 explains that the existence of free cash flow allows the CEO to follow a personal strategy in contradiction to the interests of the shareholders.
8. H. Simon, "From substantive to procedural rationality." In H. Simon, ed. *Models of Bounded Rationality*, vol. 2 (Cambridge, Ma., The MIT Press. 1982) pp. 129-148.
9. D. North, "Five Propositions about Institutional Change." Working Paper, Center for the Study of Political Economy, Washington University, St. Louis, USA, 1993.
10. We would like to signal that the objective of the present paper is neither an explanation of the genesis of mental patterns nor an exhaustive description of a particular pattern. The student interested in these matters may refer to the excellent review of the literature proposed by J. Walsh, "Managerial and Organizational Cognition : Notes from a Trip Down Memory Lane," *Organization Science*, vol.6, no. 3 (1995) pp. 280-321.Our aim is simply to make the concept operational in an explanation of the choice of finance.

11. A. Shleifer and R. Vishny, "A Survey of Corporate Governance," *The Journal of Finance* (1997) pp. 737-783.

12. M. Jensen and W. Meckling, "Theory of the Firm : Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, 3 (1976) pp. 78-133.

13. For a discussion of the theoretical stakes in a conception of value as being identical with shareholder value, the interested reader may refer to G. Charreaux and P. Desbrières, " Gouvernance des entreprises : valeur partenariale contre valeur actionnariale," *Finance Contrôle Stratégie*, vol.1, no.2 (1998) pp. 57-88.

14. R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny, "Legal Determinants of External Finance." NBER working paper 5879, 1997.

15. M. Harris and A. Raviv, "The Theory of Capital Structure," *The Journal of Finance*, vol. 46, no. 1 (1991) pp. 319-325.

16. M. Paquerot, " Stratégies d'enracinement des dirigeants et prises de contrôle d'entreprises." PhD Thesis, Université de Bourgogne, Dijon, France, 1996.

17. R. Castanias and C. Helfat, " Managerial Resources and Rents," *Journal of Management*, vol. 17, no.1 (1991) pp. 155-171.

    R. Castanias and C. Helfat, " Managerial and windfall rents in the market for corporate control," *Journal of Economic Behavior & Organization*, 18 (1992) pp. 153-184.

18. One may refer to D. North, *Institutions, Institutional Change and Economic Performance* (Cambridge, Cambridge University Press. 1990).

19. S. Ravid and E. Sudit, "Power seeking managers, profitable dividends and financing decisions," *Journal of Economic Behavior & Organization*, vol. 25 (1994) pp. 241-255.

20. This mechanism is explained by A. Shleifer and R. Vishny, "Management Entrenchment – The Case of Manager-Specific Investments," *Journal of Financial Economics*, 25 (1989) pp. 123-139.

21. Hence, certain implications of the financial model of agency theory keep their validity, but should be stated more moderately in a setting with managerial discretion.

22. We do **not** refer to Jensen's (1986) free-cash-flow concept. In fact, the latter supposes that, at a given instant, the investment opportunity set is an externally determined parameter. This approach however seems incompatible with the idea that an (organizational) entrepreneur is capable of creating new opportunities, which were unknown before. This theoretical perspective is the only one consistent with the hypothesis of

procedural rationality which underpins our study. For this reason, is considered to be excess cash-flow the sum of internally generated financial resources available to fund new investment projects.

23. The interviews with these three persons have all taken place in 1998.

24. According to *La Tribune* of September 2, 1986, between 1978 and 1986, the CEOs have followed one another "a little bit fast".

25. This concerns bonds of a value of 9.1 billion French Francs, subscribed to by the FIS (*Fonds d'Intervention Sidérurgique*, a State organism) in 1983 and 1985.

26. Interview of Mai 27, 1998.

27. Interview of November 13, 1998.

28. Interview of Mai 27, 1998.

29. Usinor, "The President's Message to the Shareholders", Annual Report 1996.

Appendix 1 – Evolution of the Financial Structure of the Usinor Group*

(amounts correspond to million French Francs)

Year	1988	1989	1990	1991	1992	1993	1994	1995	1996
External Equity	4000	4000	4000	9285	9285	9285	9285	15168	15168
Internal Finance	28644	43867	40587	37806	32509	26866	25671	24903	24028
Financial Debt	33161	32181	37790	33273	33141	30933	23090	15037	12538
Equity / liabilities	0,05	0,04	0,04	0,09	0,10	0,11	0,12	0,21	0,22
Internal Finance / liabilities	0,36	0,44	0,38	0,36	0,34	0,31	0,33	0,34	0,35
Financial Debt / liabilities	0,41	0,33	0,36	0,32	0,35	0,36	0,30	0,21	0,18

* The data stem from the group's annual reports and from the "document of reference" for privatization. In order to ascertain the comparability of data over time, we made certain adjustments.